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## EFFECTIVE POLICIES TARGETING THE CORRUPTION – ORGANIZED CRIME NEXUS IN BULGARIA: CLOSING DOWN DUTY-FREE OUTLETS

Duty-free trade-related smuggling of excise goods has been one of the most potent and sustainable sources of political corruption in Bulgaria for the last fifteen years. The operation of land border area outlets has been a major channel for flooding the Bulgarian market with tons of illegal cigarettes and alcohol and the sale of millions of gallons of excise-free petrol. The resulting profit, running into hundreds of millions each year, has been funding many a Bulgarian party and has become the foundation of untouchable political oligarchies. While the fortune of other illegal markets has ebbed and flowed, duty-free shops and petrol stations have enjoyed the protection of *all* governments since the beginning of the 1990s. Several attempts to close them down have come against the significant state-capture power of the duty-free operators. Not only have their operation not been curtailed following Bulgaria's EU membership – as members of the Bulgarian government have insisted and pledged to do – but a law was passed granting duty-free operators the right to offset closures of their units along Bulgaria's EU external land borders' entry routes with new ones at the EU external borders' exit routes with Turkey, Serbia and Macedonia.

Thus, a decisive policy limiting duty – free operators' negative impact on the Bulgarian

### MAIN POINTS:

- duty-free sales in Bulgaria reached an all time high in 2006 of over one billion levs signaling increased smuggling and illegal profits;
- duty-free trade in Bulgaria is concentrated in the hands of a few powerful figures closely connected to top government institutions and party leaders;
- through the Law on Duty-Free Trade adopted in the very end of 2006, Bulgarian MPs reversed government's public and international commitments to gradually close down duty-free outlets along land borders by granting industry incumbents permanent licenses without tendering, and giving them the right to offset lost outlets on Bulgaria's EU external borders' entry routes by opening new ones on Bulgaria's EU external borders' exit routes;
- the operation of duty-free shops and petrol stations hurts the Bulgarian economy, nurtures powerful economic interests linked to organized crime and fuels political corruption;
- closing duty-free shops and petrol stations at all Bulgarian borders is a simple litmus test for the willingness of the Government of Bulgaria to fight political corruption and organized crime – it is a straight-forward decision, that does not require any technical expertise, affects very few business interests and benefits the whole Bulgarian economy and society. More than any other policy option in the rule of law/anti-corruption area such decision requires political will only.

economy and society through discontinuing their operations is a key litmus test for the resolve of the government to deal with high level political corruption.

### *Duty-Free Outlets in Figures: Defying the Boundaries of the Physically Possible*

As early as 2001, the Center for the Study of Democracy demonstrated in its reports, that the state budget was losing hundreds of millions of leva through smuggling carried out by duty-free shops and duty – free petrol stations. The surveys in the biggest cities of the country showed that up to 90 % of the imported cigarettes at that time had labels indicating that they had been bought at duty-free shops. Year after year duty-free sales of goods and of fuel break record levels but 2006 saw by far the highest hikes. **In 2006 the Bulgarian government began to raise excise taxes more steeply to reach minimal EU levels**, which made smuggling even more lucrative.

As evidenced by the Minister of Finance, cigarettes sold through duty-free shops amounted to 5,090 tons in 2006, up 91% on 2005. Duty-free cigarette sales increased almost four times in a year without any underlying rise in the flow of passengers or any changes in the demand for cigarettes in neighboring countries. Compared to domestic sales of about 13,000 tons by Bulgartabac in 2006, the state-owned monopoly producer of Bulgarian cigarettes, **duty-free sales of cigarettes amounted to 38% of the Bulgarian domestic market**. This would have been physically unfeasible to realize if duty-free sales were sold in retail quantities only. Although shuttle trade flourishes along Bulgarian land borders, such sales would still be impossible to realize without large smuggling operations inside the country.

**Table:** Turnover of duty free shops at Bulgarian borders

	Packs of cigarettes sold	Cigarettes sold – statistical value (levs)	Alcohol sold – net weight (kg)	Alcohol sold – statistical value (levs)	Passenger flow registered at the Bulgarian state borders
2001	61,241,433	95,717,500	1,413,227	19,959,969	15,302,434
2002	46,119,000	84,831,963	1,191,953	14,941,031	17,183,454
2003	61,154,267	116,437,862	1,166,377	17,201,439	18,963,469
2004	87,643,200	152,356,553	1,420,344	20,877,585	21,392,003
2005	88,602,733	145,823,774	1,743,964	25,550,355	22,807,386
2006*	<b>339,734,333</b>	<b>559,202,707</b>	<b>2,451,012</b>	<b>33,882,982</b>	<b>23,252,594</b>

Note: \* Total values for 2006 are calculated on the basis of unit values from 2005 data.

Source: Customs Agency, General Directorate of the Border Police

As regards fuel duty-free sales, the situation is similar if not worse. The Bulgarian Ministry of Finance data revealed that duty-free petrol stations sold 321 million liters of diesel (84.5 million gallons) in 2006, which represents 15% of the domestic diesel market (including the segments for cars, trucks, heating, etc.). The stations also sold 53 million liters (14 million gallons) of unleaded petrol. Duty-free diesel sales roughly doubled in 2006 compared to 2005. According to statements of the Ministry of Finance duty-free revenues from diesel fuel sales amounted to 300 million leva in 2005, while the total profit tax paid by the duty-free operators was 22 million leva. The numbers

suggest that the volume of sales has been rising and is higher than the physical capacity of the petrol stations for retail sales. This leads to the conclusion that **a substantial part of the fuel sold at the duty-free petrol stations returns back into the country or never reaches the pumps of the duty-free petrol stations** avoiding excise and VAT duties and generating huge illegal profits for their owners.

According to the Ministry of Finance data (presented at a May 2006 hearing of the Parliamentary Anti-Corruption Committee) in 2005 the budget lost as much as 95 million leva in revenues from the operation of the duty-free petrol stations. The MoF calculations are made on the basis of official duty-free sales and on the assumption that none of the fuel was smuggled into the country. However, the operation of duty-free shops and in particular duty-free petrol stations at the Bulgarian borders harms not only the national and European budgets but also hurts competition at the local market, disadvantaging non-travelling Bulgarian consumers and domestic petrol retailers. Petrol retailers in Bulgaria, such as the large international investors Shell and OMV have repeatedly voiced their opposition to the functioning of the duty – free petrol stations, noting that as much as 30% of the local fuel market lies in the shades, with 2/3 of the market belonging to sole retailers. Probably the most damaging long term effect to the democratic and free economic development of Bulgaria and the region comes from the powerful economic lobbies and undeclared profits that the operation of duty-free shops and petrol stations creates:

- at the micro, **border area**, level, through the operation of duty-free shops **thousands of people engage in smuggling of small quantities of excise goods and petrol**. This creates a specific hush-hush environment in the border regions, corrupting the social fabric of the local community and nurturing local oligarchs. While shuttle trade might have had a positive social effect in the mid 1990-ies, now as Bulgarian is an EU member its impact on the economy and society is predominantly negative;
- at the macro, **national level** illegal proceeds from duty-free trade have been deployed to capture the state, using **political corruption to secure perpetual monopoly business positions** to a selected well-connected few at the expense of the Bulgarian and European taxpayers.

### *Buying Duty-Free Regulation*

The regulation of duty-free operators in Bulgaria since their inception in 1992 bears all the marks of a **state capture**. Duty-free operators have been able to effectively impose their interests on the Bulgarian society through the Bulgarian Parliament, sabotaging public and international commitments undertaken by two subsequent governments. In 2004 the Finance Minister had to concede defeat and extend duty free operators' licenses until 2009 – 2011 after failing to materialize a commitment to close down duty-free shops. In 2006 the public interest suffered another humiliation after the Ministry of Finance and the Bulgarian Parliament crippled the government's proposal for a *Law on Duty-Free Trade*, effectively granting permanent licenses for duty-free trade to all existing operators and providing them with the right to open new units at Bulgaria's EU external land borders' exit routes to compensate for the ones they had to close at EU external borders' entry routes after 2007. This is in short how Bulgarian MPs legally cemented monopoly rights of operating a business that hurts fair competition and local taxpayers. The MPs provided for only two clauses of control on the operation of duty-free shops and petrol stations,

and shied to introduce restrictions on the amount of individual sales, which the Bulgarian Ministry of Finance had originally planned. The law was adopted on December 18th, 2006, at one of the last sittings of the Bulgarian parliament before EU entry. Tellingly, the decision was taken unanimously, with no opposition voiced in the plenary, although the law clearly breached Bulgaria's IMF commitments and the interests of the Bulgarian people.

The failure of the Bulgarian government to defend the principles of free and fair competition can be traced in a series of Letters of Intent and Supplementary Memorandums of Economic and Financial Policies provided by the Government of Bulgaria to the International Monetary Fund:

- on June 18, 2003, through the signatures of the Minister of Finance and the Governor of the Bulgarian National Bank, the GOB stated that: «To combat customs fraud, new counterfeit-proof banderoles for cigarettes and alcohol will be introduced, border point duty-free shops will be closed except at airports, and the recommendations from the Crown Agents consultants implemented.”;
- on April 26, 2005, the government has clearly toned down their resolve in the light of the renewal of duty-free operators' licenses by the Bulgarian Ministry of Finance in 2004: «The tax losses will be mitigated by higher excises on alcohol and tobacco products in line with EU accession requirements, a slight broadening of indirect tax bases, and improved compliance in response to various measures. In this connection, the government has taken steps, in cooperation with our external consultants, to reverse the surge of excise tax refunds to duty-free shops and gas stations, including through the establishment of an interagency National Control and Coordination Center and the creation of additional mobile teams focused on the prevention of excise tax fraud.”
- on March 14<sup>th</sup>, 2006 the Bulgarian government, in the face of the Minister of Finance, the Minister of Economy and Energy and the Governor of the Central Bank, pledged: “We will step up efforts to reduce revenue losses from the operation of duty free shops and gas stations. A law on duty free trade specifying limits on individual purchases of goods and fuels, and strengthened controls, will be submitted to parliament by March 31, 2006 with a view to passage by June 30, 2006 (a benchmark). As an immediate step, we have increased surveillance of these outlets to limit abuses of their duty-free status. We are also examining measures to close duty-free outlets within Bulgarian territory or to relocate them to customs areas along the border. The justification of duty free outlets along borders with EU members ceases with EU accession. Closing those along other borders should proceed on a reciprocal basis in close cooperation with the countries concerned. Over time, we believe that duty free outlets should be limited to international airport terminals.”

**The government of Bulgaria has clearly failed to meet its obligations** undertaken in the above-mentioned letters and benchmarks. It is noteworthy that the letters were prompted by the government itself, which makes its failure all the more telling about the state capture powers of duty-free operators. The final texts of the *Law on Duty-Free Trade* have been amended to protect the monopoly interests of the current duty-free operators to the best possible extent.

In its concluding remarks to the consultations with the Bulgarian government the IMF mission of

May 17, 2006 underlines that: “There is evidence that the declining trend in corruption reported since the late 1990s has come to an end. Implementation of the government's anti-corruption strategy has fallen short of its objectives. Improvements to public procurement procedures would help in this regard, as will legislative initiatives such as the new [draft] duty-free trade law. But results in the fight against corruption will depend ultimately on the political will of the government, parliament and other institutions.”

The 2007 International Narcotics Control Strategy Report, prepared by the US Department of State, depicts well the unwillingness and inability of the Government of Bulgaria to contain smuggling through duty-free shops and petrol stations:

“Since 2003, the operation of duty free shops has been targeted by the Ministry of Finance (MOF) as part of its efforts to address the gray economy and the smuggling of excise goods. Duty free shops play a major role in cigarette smuggling in Bulgaria, as well as smuggling of alcohol, and to a lesser extent perfume and other luxury goods. Attempts by the MOF to close down shops operating in Bulgaria have been unsuccessful, in part due to political opposition within the ruling coalition. The focus of the Government of Bulgaria (GOB) has been on the duty free shops used to violate customs and tax regimes. The duty free shops may be used to facilitate other crimes, including financial crimes. Credible allegations have linked many duty free shops in Bulgaria to organized crime interests involved in fuel smuggling, forced prostitution, the illicit drug trade, and human trafficking. There is no indication, however, of links between duty free shops or free trade areas and terrorist financing. The MOF's Customs Agency and General Tax Directorate have supervisory authority over the duty free shops. According to these authorities, reported revenues and expenses by the shops have clearly included unlawful activities in addition to duty free trade. Good procedures for identifying unlawful activity are lacking. For example, MOF inspections have revealed that it is practically impossible to monitor whether customers at the numerous duty free shops have actually crossed an international border.”

### *Testing the Anti-Corruption Political Will in Bulgaria: Closing Duty-Free Outlets*

Closing down duty-free outlets remains a straight forward policy decision to test the political will of the government to fight political corruption and organized crime:

- it is a **simple, non-technical issue that does not involve any additional complex reform efforts** and does not require anything more than political will;
- it **affects** only a **very few prominent business figures**, who have become emblems of organized crime in Bulgaria, well known for close contacts with top government institutions and political parties;
- it is supported by the rules of fair competition and will benefit domestic consumers and businesses, **reducing the resources for corruption** and **shrinking the grey economy**. Even in the case of legal action and penalty compensations against the government, benefits will by large outweigh costs;
- it will **send a clear signal** to Bulgaria's EU and international partners that the Bulgarian government takes anti-corruption and rule of law very seriously and will produce a hurting blow right in the heart of organized crime.

There are **two possible courses of action** towards reducing the negative effects of duty-free outlets through changes in the *Law on Duty-Free Trade*:

- **closing down duty-free shops and petrol stations**, e.g. as of June 2008. Compensations would most probably have to be negotiated in international arbitration courts but with immediate positive impact on the economy (radical approach);
- **banning the sale of cigarettes** at duty-free shops and **introducing limits on the sales of petrol stations**: 30 litres for passenger cars and 200 litres for trucks and heavy vehicles. No compensations will apply in this case but strict control and enforcement will be required (moderate approach).